The Achievements and Challenges of EU Financial Integration and the Implications for the US

This is my first public presentation in my new role as head of the Markets Group. The shift to the public sector from the private sector means I must be much more sensitive with my public comments. I would characterize one of the major changes from this shift as: Spending more time thinking, less time talking.

With that in mind, I want to start with an important and necessary preamble before my remarks: I am speaking for myself today. My comments do not necessarily reflect the views of the Federal Reserve Bank of New York or the Federal Reserve System.

First, I want to applaud the efforts of the EU and the ECB to foster financial market integration and to take steps to encourage the development of their capital markets. In my view, greater integration will help improve the allocation of resources and increase the degree of competition—both factors that should help lift productivity and, more generally, help lead to good economic performance in the Euro area.

Second, I want to emphasize that in terms of development of the capital markets, we are in the middle of a revolution—a shift from depository institutions making credit decisions, lending funds, and keeping these loans on their balance sheet—to a brave new world—in which the credit decision does not end up in the bank's portfolio and may not even be made by a bank—but is instead packaged and distributed to other financial market participants via the capital markets. This shift has facilitated the broad dissemination of risk and has allowed investors to more efficiently diversify their portfolios—either earning higher returns, at the same level of risk than before—or earning the same returns at lower risk.

A few years ago, Glenn Hubbard and I wrote a paper entitled: *How Capital Markets Enhance Economic Performance and Facilitate Job Creation*. The main thesis of the paper was that well-developed capital markets generate many economic benefits including higher productivity growth, greater employment opportunities, and improved macroeconomic stability. In addition, we argued that the ascendancy of the capital markets has contributed to improved policymaking. The capital markets respond to policy developments. Good policy is usually rewarded and bad policy is typically punished by the markets. Finally, the development of capital markets speeds the transmission of monetary policy. Markets react on the anticipation of policy changes and this helps to speed up the transmission process.

On balance, the empirical evidence that we examined suggested that the development of the capital markets in the United States had facilitated improved economic performance and that the US led, in this area, compared to Europe and Japan.

Although the paper is several years old, I think that its thesis is still well-supported by the available evidence. There is a difference though--Europe is catching up rapidly—closing the gap with the United States.

First, financial integration is proceeding at a rapid rate.

Second, the capital markets are becoming a much more important part of the intermediation process.

Nevertheless, despite the progress made in Europe, there is still work to be done. Of course, the same is true for the US. Consider, for example, the complexity of the structure of US financial system regulation or, as some argue, the burdens imposed by Sarbanes-Oxley. But the subject today is Europe, so that's where I will put my focus.

As I see it, Europe has more to do in four major areas:

First, the US Treasury debt market remains the deepest and most liquid in the world, despite the fact that the nominal value of sovereign debt outstanding in the Euro area is considerably larger than in the United States. This is, of course, due to the fact that sovereign debt in Europe remains fractured among the many countries of the Euro-zone. Also, differences in local practices and in types of debt instruments have impeded integration and economies of scale and scope in this area.

Second, the number of payments and settlement platforms in Europe remains very high. The ECB is in the midst of several initiatives to address this issue—for example, the Target2-securities proposal would result in significant consolidation and improvement. But, even if this project goes forward as planned—and that is not completely certain—completion still lies several years away—the timeline that I have seen suggests that this new protocol will not be fully implemented until 2013.

Third, there has been less cross-border consolidation of the banking system within Europe compared to what has taken place in the United States. The United States—which started with a much more fractured system across 50 states—has seen the development of several banks with broad geographic reach across the United States.

Fourth, European equity markets are smaller and more fragmented than in the United States.

In terms of the outlook for financial market development, I expect that the process of integration in Europe will proceed—a bit slower than hoped and probably a bit faster than feared.

So what does this imply for the United States?

First, I think that the US should welcome such integration. Although an integrated European financial system would undoubtedly make the Euro even more competitive with the dollar as a reserve currency, this is mostly not a zero-sum game. What's good for Europe is not by extension bad for the United States. If we do our job well here in the US, then I don't think we have to worry much about the dollar and its role as reserve currency.

Second, on the reserve currency issue, I think there is plenty of scope for important roles for both the Euro and the dollar. Currently, we see evidence that suggests that the Euro's role is increasing in global finance.

The growing role for the Euro can be seen in a number of respects:

1. The growth rate of currency outstanding. US currency—of which about two-thirds is held overseas—is growing more slowly—the growth rate has slowed to only about 2% on a year-over-year basis. Euro currency growth has slowed a bit as well—probably because emerging economies are performing so well, but it is still growing many times faster at about a 10% pace.
2. The share of the Euro as a percent of foreign exchange reserves. The data here are less than perfect as some central banks with very large reserves do not report the composition of their reserves. But it looks like—adjusting for foreign currency valuation effects—that the Euro is very slowly gaining share, and the dollar is slipping slightly.

With respect to foreign central bank reserve holdings, I think this is precisely what one would expect.

First, efficient portfolio construction implies that greater diversification makes sense.

Second, the gentle rise in the Euro share should be expected given the progress made by Europe. The gap between Europe and the United States is closing as the European financial system's breadth and integration increases and its financial system grows to look more like the financial system of the US.

At the same time, the dollar still plays the central role in global capital markets. For example, this can be seen in foreign exchange trading, where dollar-based currency pairs make up the bulk of all trading activity.

Let me conclude on an optimistic note: In both Europe and the US, inflation expectations are well-anchored, inflation and inflation volatility are low. In other words, policymakers in both regions have been doing a good job in preserving the purchasing power and, hence, the store of value function, for their currencies. This means that both the dollar and the euro remain attractive to foreign investors. Fortunately, in recent years it has mostly been a race to the top rather than to the bottom. So much for Gresham's law which says that the bad money will drive out the good! In this case, in many ways, the quality of money has been improving.

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